under construction, serving more than 600 communities (and more than 9,000 buildings), and will have total 1995 revenues exceeding $1.2 billion. ALTS projects total "competitive industry" revenues to increase sixteen fold to $20.3 billion in 1998. More than one hundred competitive switches are expected to be operational by the end of the first quarter of 1996.[61] TCG and MCI Metro have completed their fiber buildouts in downtown San Francisco -- we know, because they encircle our headquarters. According to Bellcore, MCI has already installed 10 switches around the country.

While IXCs complain that there are thousands of LEC switches, that misses the point. These thousands of switches result from our obligation to serve all customers at averaged rates. They represent a burden, not a benefit. If competitors need collect only the best ten percent of our customers, as we know they do, then all other things being equal (which they are not -- LEC switches being far more likely than their competitors' switches to be antiquated), they need only ten percent of our switching capacity to take all of our profits. Absent substantial changes to universal service burdens and obligations to serve, there will never be any reason for an IXC to install thousands of end office switches.

Although the Commission has expressed its concern about reviewing data for individual wire centers, there would not be a different filing for every wire center. The Commission would merely confirm the existence of competitors' facilities, through information collected via survey; through the issuance of a data request or request for comments on the LEC's competitive showing; or from other public records, and the access services in the wire center, or wire centers, through which the facilities pass would qualify for contract carriage.

As contracts with customers are executed, they will be filed with the Commission (with competitively sensitive information masked), according to the same general principles that

[61] *Telecommunications Reports*, Nov. 6, 1995, p. 1.

govern the filing of contracts with the CPUC (see above, pp. 11-13). Any other customers who qualify may take advantage of the terms and conditions in the filed contract. In addition, taking service under the tariff will always remain available as an option to all customers in all markets for all services.

There will need to be a one-time adjustment of our price cap or service band indices to reflect the reduction in revenues when a contract takes effect. We suggest that in the annual filing, a rate element line be added to each service band affected by contracts that took effect during the base demand period. This line will contain the aggregate price reductions in that service band as a result of any contracts. Because of the requirements of the price cap model, the current price will be the aggregate revenues before contracts, and the proposed price will be the aggregate revenues after contracts with a base period demand of one. The base period demand for the rate elements affected by contracts will also be reduced to reflect only the quantity being offered at the tariffed rate and to avoid double-counting the revenues received from those rate elements. Subsequent reductions in contract prices, a likely effect of increased competition, will therefore not result in any increase in "headroom" (*i.e.*, additional upward pricing flexibility) for the affected baskets or bands. Under this proposal, we would have no more ability to increase price capped rates than the current rules afford us.

IV. Nondominant Regulation

Issue 18: *Should we adopt rules now that would define the conditions LECs must meet to be considered nondominant? If so, should those conditions be what we used in Competitive Carrier, or some other conditions? Are there any reasons not to regulate a LEC as nondominant for some services and dominant for other services? Are there any reasons not to regulate a LEC as nondominant in some geographic markets and dominant in others? What procedure should a LEC follow to obtain nondominant status? What procedures would apply to a carrier that is determined to be nondominant?*

The Commission has already determined that AT&T, with by far the greatest capacity and demand of any carrier, is nondominant.[62] Any provision of interLATA service by the BOCs will, by logic and definition, qualify for nondominant treatment.

Some of the criteria the Commission proposes to require before nondominant treatment is allowed are superfluous. If a carrier has no market power -- which may be determined using the four criteria the Commission proposes for purposes of streamlined regulation -- then no price regulation is required. However, if interstate access services can be offered under contract in competitive areas, we see no immediate need to resolve this inconsistency in the Commission's logic.

Issue 21: *Under what circumstances would the treatment of access charges imposed by LECs and other providers under AT&T's price cap plan create actual bias in the access services market? Is there any reason not to treat CAP and LEC charges the same under the AT&T price cap plan?*

This issue appears to have been mooted by the nondominant treatment of AT&T.

[62] See AT&T Non-Dominant Order.

V. Conclusion

We urge the Commission to adopt the reformed price cap structure that we have presented in these Comments. We also urge the Commission to adopt a streamlining proposal that is: (1) simple to administer; (2) reflects the substitutability of switched and special access, to say nothing of their subparts, in competitive geographical areas; (3) and is not inconsistent with the Commission's existing policies on total cost recovery and rate rebalancing in higher cost areas.

Respectfully submitted,

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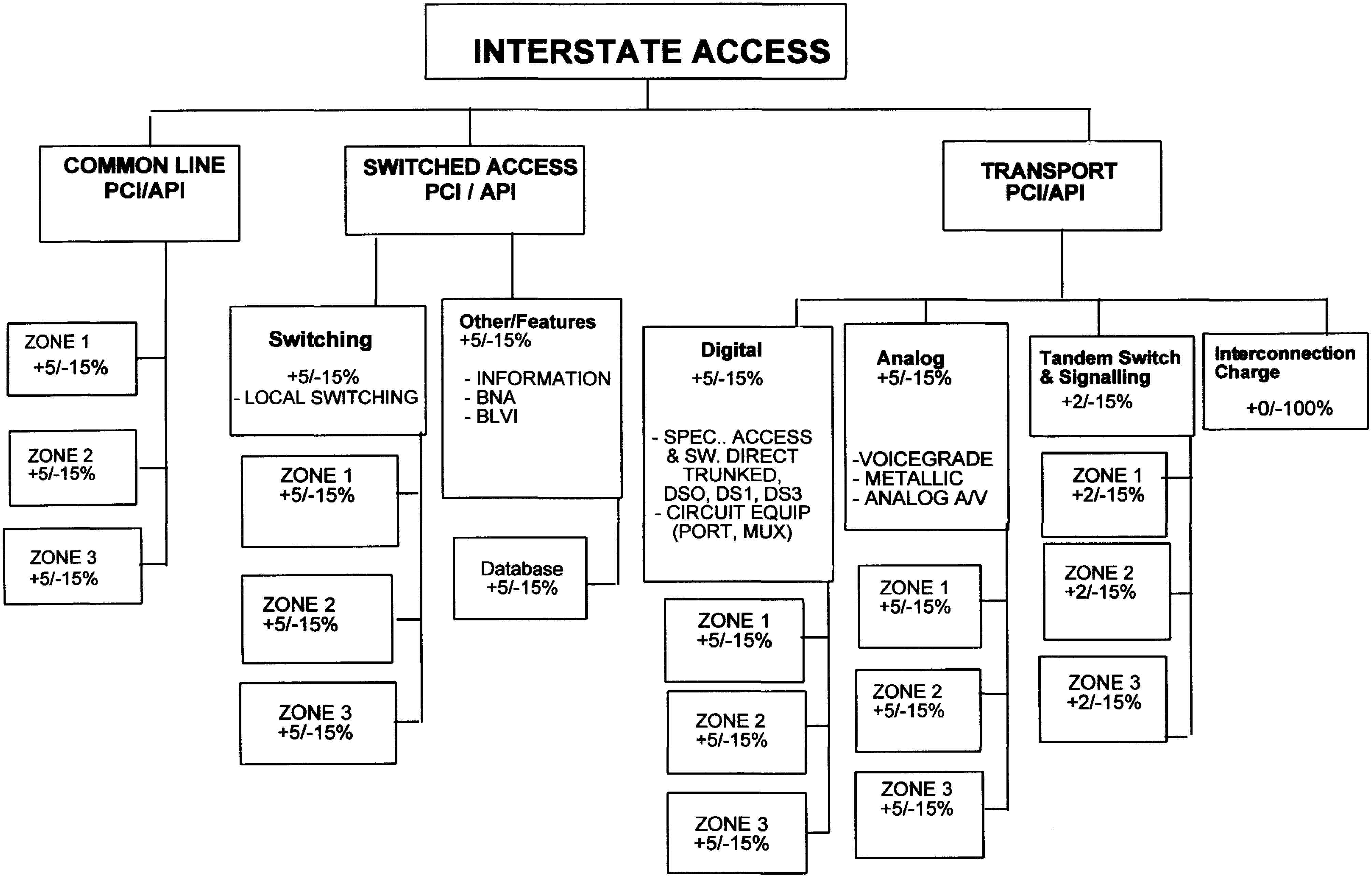
Date: December 11, 1995

PACIFIC BELL'S PROPOSAL FOR PRICE CAP REFORM

Figure 1

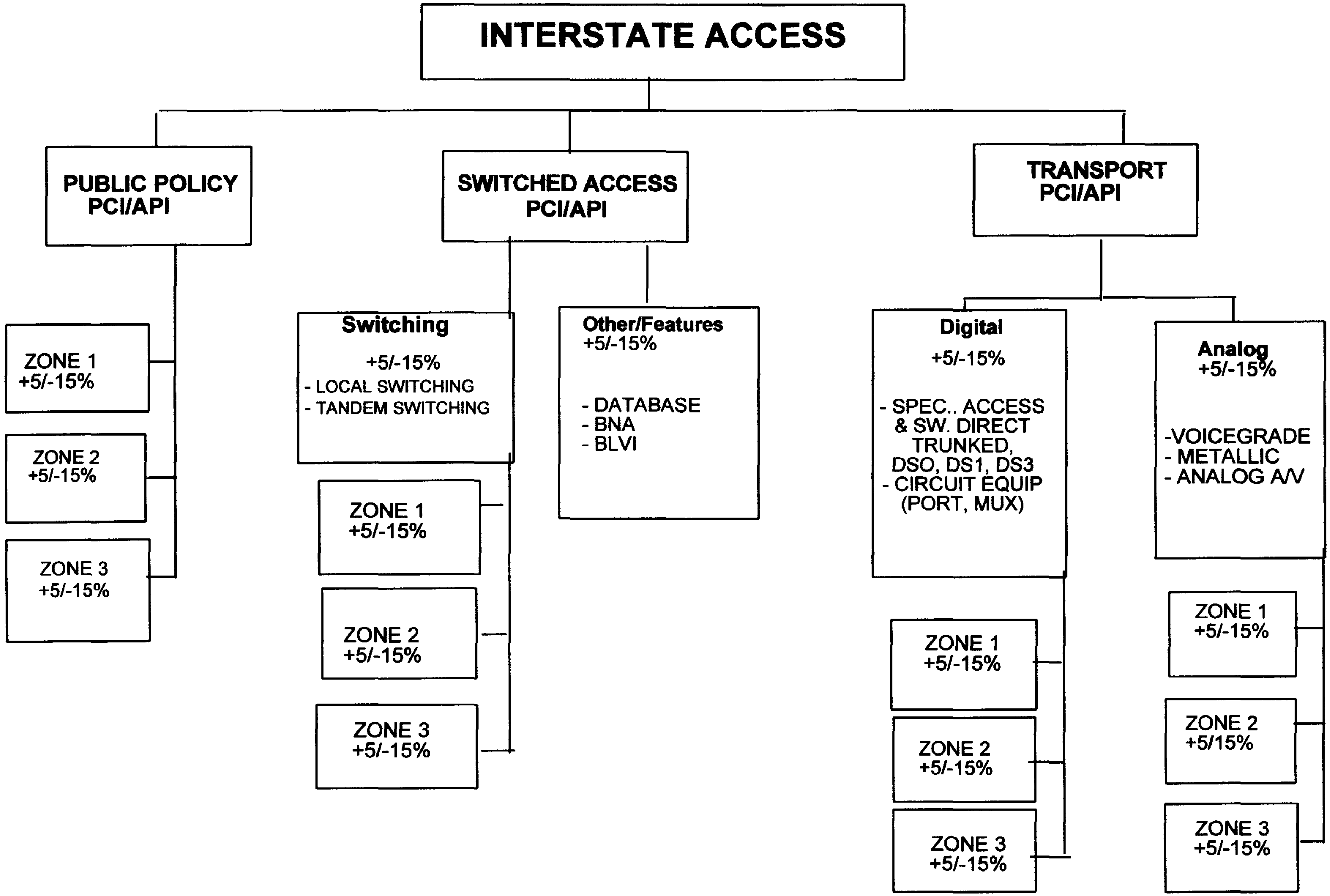
PRIOR TO DOCKET 91-213 AND 800 DATABASE RESOLUTION



PACIFIC BELL'S PROPOSAL FOR PRICE CAP REFORM

Figure 2

AFTER DOCKET 91-213 AND 800 DATABASE RESOLUTION



ATTACHMENT 1

KAHN-TARDIFF REPORT

CHANGES IN INTERSTATE PRICE REGULATION: AN ECONOMIC EVALUATION OF THE PACIFIC BELL AND NEVADA BELL PROPOSAL

Prepared for Pacific Bell and Nevada Bell

by

Alfred E. Kahn* and Timothy J. Tardiff**

December 11, 1995

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CHANGES IN INTERSTATE PRICE REGULATION: AN ECONOMIC EVALUATION OF THE PACIFIC BELL AND NEVADA BELL PROPOSAL

Alfred E. Kahn and Timothy J. Tardiff

I. INTRODUCTION

In its Second Further Notice of Proposed Rulemaking in CC Docket No. 94-1, the Federal Communications Commission (FCC) requested comments on proposed changes in its price cap regulations for local exchange carriers (LECs). The proposed changes are of three kinds: (1) revisions to make price cap regulation more compatible with the state of competition, (2) streamlined regulation for services subject to sufficient competition and (3) nondominant treatment as the end-state of regulatory intervention, short of total deregulation.

In their comments in response to this Notice, Pacific Bell and Nevada Bell (Pacific) have addressed themselves to the specific questions posed in the Notice and have presented its plan for modifying price caps. Our paper has two objectives. First, we present the economic principles that should guide the transition to what we anticipate will ultimately be a state of vigorous competition in most telecommunications markets. Our main message is that (1) services subject to competition should be deregulated as soon as practicable, (2) regulation should be limited to services in the supply of which the LECs have substantial market power *and* that are essential either to end-use customers or as inputs for competitors and (3) that residual regulation and the Commission's proposed changes in it should be rendered as compatible as possible with the requirements of efficient competition and should conform as closely as possible with the results that such competition would produce if it were feasible.

Second, we describe and evaluate Pacific's proposed modifications of price cap regulation in the light of these principles.

II. EFFICIENT REGULATION OF THE INCREASINGLY COMPETITIVE TELECOMMUNICATIONS INDUSTRIES: ECONOMIC PRINCIPLES

A. The Goals of Regulation

The Notice provides a succinct statement of the economic goal of regulation that coincides with the position we have long advocated.

> A goal of our policies is to promote economic efficiency, which includes regulating prices so that they emulate the economic performance of competitive markets as closely as possible until actual competition arrives. This will ensure that the consumer welfare benefits approximate those of competitive markets, which should result in just and reasonable rates.[1]

There are three important themes in the FCC's description of its goal. First, price regulation is an inferior substitute until such time as competition can take over the role of protecting consumers and promoting the public welfare. Second, the standard for judging whether or not a particular exercise of price regulation promotes economic efficiency is whether or not the prices it permits or sets emulate the prices that would prevail in effectively competitive markets; and, third, that it is as compatible as possible with efficient competition. Since we agree completely with the first of these propositions,[2] we confine our comments to the implications of the other two.

B. Performance of Prices in Competitive Markets

The Commission's acceptance of the competitive standard as the basis for its having moved from traditional ratebase/rate-of-return to price regulation and for the proposed changes in its price cap regulations—which we of course applaud—calls for a consideration of the way prices

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[1] Federal Communications Commission, In the Matter of Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, Treatment of Operators Services Under Price Cap Regulation, CC Docket No. 93-124, Revisions to Price Cap Rules for AT&T, CC Docket No. 93-197, Second Further Notice of Proposed Rulemaking in CC Docket No. 94-1; Further Notice of Proposed Rulemaking in CC Docket No. 93-124, and Second Further Notice of Proposed Rulemaking in CC Docket No. 93-197, September 20, 1995, p. 11 ("Notice").

[2] We recognize that competition in the real world is inevitably imperfect as well. As a general proposition, however, we believe that wherever competition is feasible, even if only imperfectly so, it is likely to be preferable to likewise inevitably imperfect regulation; in this, we believe our views are essentially in accord with those of the Commission.

do indeed perform in competitive markets somewhat closer than the Commission appears to have undertaken in the present Notice of Proposed Rulemaking. As a general proposition, the superiority of competition over regulation inheres in the greater pressures that it exerts on producers to improve their productivity over time and to pass the benefits of those improvements on to consumers in the form of prices lower than would prevail under regulation. It does not follow, however, that average prices in competitive markets only decline over time; and this is even less true of individual components of those averages.

1. Competitive prices may either increase or decrease, depending on what is happening to costs and demand conditions

The FCC appears to believe that the LECs' interstate prices will generally decrease: "we expect the pricing flexibilities that we propose here will result primarily in rate reductions."[3] Of course, if the revisions *permit* only reductions, not increases—as the Commission's proposed changes in the rules have some tendency to do[4] that expectation is likely to be borne out—but only in the short run, and only as long as it is compatible with the companies earning a going return on their invested capital. The significant fundamental point is that such an asymmetrical relaxation of regulatory limitations would not accord with the competition standard: there is no basis in competitive markets for the expectation that *average* prices should and can be expected only to decline over time.

First and foremost, competitive prices respond to the trends in underlying costs. The fact that the rate of inflation in the economy generally has been positive over the last 55 years demonstrates that competition by itself is not sufficient to guarantee declining nominal prices. Even in the communications industry, which has outperformed the economy in terms of productivity achievement and average prices have therefore declined in real terms, prices have typically increased by about 1.5 percent per year in non-inflation-adjusted terms.

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[3] Notice, p. 16.

[4] In par. 105, the Notice proposes to limit to 1 percent upward pricing flexibility for any service category or subcategory for which the LEC has previously taken advantage of the ability to exercise downward flexibility (Notice, pp. 47-48). Second, when services are removed from price caps, price reductions for these services would no longer count in calculating average prices under price cap formulas. By simple arithmetic, this would have the effect of restricting the upward flexibility on services in the same band or basket (before streamlining), because the LEC would no longer receive "credit" for those price reductions.

Second, even in competitive markets in which prices decline on average, some components of the average may well increase. In interstate toll services, for example, where the Commission recently granted AT&T non-dominant status, a very large group of subscribers have experienced price increases over the past several years, despite the widespread availability of discount plans: since 1992, the consumer price index for interstate toll (which tracks nondiscounted toll prices) has increased by about 10 percent, even though carrier access charges have continued to decline. This performance has raised some legitimate doubts about the adequacy of competitive restraint in these markets; but the mere fact that the rates paid by the large group of subscribers who have not qualified for discounts have increased in no way necessarily demonstrates in itself that competition has been ineffective or inefficient.

Another revealing example is the performance of prices under airline deregulation. Although prices have declined on average and consumers have reaped enormous benefits from the ensuing intensification of competition, the distribution of these benefits has been far from uniform. In part, as we will observe shortly, the absolute increases in some fares were merely a correction of previous regulatorily-imposed cross-subsidizations of that traffic. But the intensification of price competition has contributed also to an intensification of price discrimination. In the first ten months of this year, 92.5 percent of all domestic passenger mileage was flown at discount fares, with an average discount of 68.5 percent off the regular coach fare. In contrast, the full fares paid by preponderantly business travelers have increased sharply in real terms.[5] While price discrimination—reflecting differences in the elasticities of demand among various categories of customers—is by definition not possible in theoretically purely or perfectly competitive markets, it can be expected to *increase* with intensifying competition in industries with a wide spread between average total cost and marginal cost; and this has been the experience in airlines.[6] Moreover, price discrimination can in these circumstances be conducive to enhanced efficiency—permitting fuller exploitation of economies of scale and fuller use of existing equipment capacity (higher airline load factors, for

[5] Information supplied by the Air Transport Association.

[6] Severin Borenstein and Nancy L. Rose, "Competition and Price Dispersion in the U.S. Airline Industry," *Journal of Political Economy*, Vol. 102 (August, 1994), pp. 653-83.

example) and therefore lower average prices than prevailed under thoroughgoing rate regulation.

Regulation that holds particular firms to the expectation of prices only declining, when the underlying cost and/or demand conditions may well dictate the opposite is likely to be inefficient and harmful to both those firms and the competitive process: prices artificially suppressed below competitive equilibrium levels discourage efficient competition itself.

2. Increased competition in markets where initial prices are inefficient will not necessarily lower all prices

Regulation grounded on the expectation that competition will produce or necessitate no price increases is especially likely to be harmful when prevailing structures of rates *relative* to one another incorporate wide deviations from economically efficient relationships, as of course they do pervasively in telecommunications in two fundamental ways. First, the societal goal of universal telephone subscription has resulted historically in explicit cross-subsidies to basic residential access services, at the expense of toll and carrier access charges, as the Commission itself has, laudably, recognized. And even where it appears rates for the former services may now recover long-run incremental costs, so that it is no longer strictly accurate to characterize them as cross-subsidized, it appears generally the case that their markups above marginal cost are inefficiently low and the markups on such services as carrier access and toll inefficiently large, in consideration of their respective elasticities of demand.[7]

The second distortion has been produced by the widespread regulatory practice of rate averaging. Until recently, interstate prices were the same across a service territory, even though the cost of providing service differed with location. As a partial remedy, the Commission recently allowed the LECs to reflect these cost differences through zone density pricing, but, by design, only gradually.[8]

These departures from the prices that would prevail in competitive markets could pose severe impediments to efficient competition for interstate services, in two ways. First, the

[7] Alfred E. Kahn "Current Issues in Telecommunications Regulation: Pricing" (with William B. Shew), *Yale Journal on Regulation*, Vol. 4, 1987, pp. 247-52.

[8] Notice, p. 9.

restrictions on full geographic rate deaveraging (and any asymmetric burden on incumbent LECs to cross-subsidize or underprice basic access) provide a price umbrella that invites potentially higher cost firms to enter. In addition to inefficient entry, pricing restrictions such as tight upper and lower bands around current prices exacerbate the potential competitive harm once entry occurs: competitors can succeed in taking over a share of the market even though their costs exceed those of the incumbent. For this reason, the Commission's interest in giving the incumbents greater flexibility to offer alternative pricing plans, new services and contracts and in eliminating the current restrictions on downward pricing flexibility are all steps in the right directions. Our main concern is about the link that the Commission apparently intends to forge between the exercise of this downward flexibility in competitive markets and continued—and even tightened—restrictions on pricing elsewhere.[9]

Second, inefficiently *low* prices will *inhibit* the entry even of competitors more efficient than incumbents and so retard the emergence of the competition that is a precondition for the elimination of restrictions on competition elsewhere—such as the prohibition of the successor Bell Operating Companies offering interLATA services. Both economic efficiency and the promotion of competition require that the prices of underpriced services *increase*.

The Commission has of course not only recognized this necessity; it has, with the subscriber line charge (SLC), contributed to its partial realization. More generally, the relative movements in the charges for interstate toll services and basic local rates illustrate the requirements of competition. Since divestiture, interstate toll prices have declined by 25 percent; the necessary accompaniment has been a 40 percent *increase* in local service prices (including, of course, the FCC SLC).[10]

The experience with airline deregulation, once again, clearly illustrates this tendency: competition has eliminated the systematic cross-subsidizations in the previous regulated price structures. Civil Aeronautics Board regulatory policies consistently set fares on long hauls above cost in order to permit below-cost fares on the short hauls. By eradicating those cross-subsidizations, competition has resulted in increases of 10 to 30 percent in inflation-adjusted

[9] See note 4, above.

[10] As measured by the telephone components of the consumer price index.

fares on routes below 500 miles while average real yields for the country as a whole declined about 33 percent between 1976 and 1993.[11]

The airline experience demonstrates how simplistic and, ultimately, unrealistic is the expectation that in real-world markets the introduction of effective competition will produce only price reductions, whether across-the-board or selectively; and, particularly in industries like telecommunications, characterized by large economies of both scale and scope, supplying a multitude of products and serving a multitude of markets, the margins between prices and marginal cost—the *efficient* margins—are likely to vary widely, in reflection of differences in elasticities of demands.

C. Residual Regulation in the Transition to Full-blown Competition

The worlds of traditional regulated monopoly and open competition in all markets may be thought of as the end points of a continuum. There is widespread agreement about those end points: at the one end,

> [T]he single most widely accepted rule for the regulated industries is regulate them in such a way as to produce the same results as would be produced by effective competition if it were feasible.[12]

At the other end, as Baumol and Sidak put it:

> Our least surprising conclusion is that, wherever they can be relied upon to do the job, market forces are preferable to governmental intervention. Whenever competition has become sufficiently powerful to protect legitimate interests of both consumers and related firms, the local telephone company should be granted full freedom from regulation, subject only to surveillance by the regulatory agency to confirm that market forces are operating as expected and have not eroded.[13]

One of us has, in an earlier phase of this proceeding, offered the following few and simple rules for the in between[14]: (1) efficient entry requires that prices be efficient, i.e., rates

[11] Steven A. Morrison and Clifford Winston, *The Evolution of the Airline Industry*, Washington: Brookings, 1995, pp. 11-12, and 19.

[12] Alfred E. Kahn, *The Economics of Regulation*, Cambridge: The MIT Press, 1988, Vol. I, p. 17.

[13] William J. Baumol and J. Gregory Sidak, *Toward Competition in Local Telephony*, Cambridge: The MIT Press, 1994, pp. 4-5.

[14] Kahn, Affidavit on behalf of Bell Atlantic, June 28, 1994.

be rebalanced to eliminate subsidies and/or competitively neutral universal service funding mechanisms be in place; (2) open entry demands deregulation of the incumbent's services that are no longer monopoly-provided; (3) price protection must be provided for purchasers of services not yet subject to widespread competition that society regards as essential components of a minimum standard of living; and (4) inputs essential for competition must be available on a non-discriminatory basis and competing LEC retail services must pass an imputation or competitive parity test.[15]

1. New services and essential facilities

The Notice discusses the regulatory treatment of essential facilities in the context of its discussion of new services. We find both the definition and the proposed regulatory treatment troubling.

So far as genuinely new services—in contrast with mere restructuring of existing services—is concerned, the Commission's proposal to subject to Track 1 treatment seems to us the opposite of what sound competitive principles would dictate.

With respect to truly new services—that is to say, ones that do not merely replace or represent a repackaging of existing ones—the conception of monopoly power in their provision is of dubious meaning. New services offer customers additional alternatives not available to them previously: their introduction is fundamentally a competitive rather than a monopolistic phenomenon, even though they may be distinctive and the innovator may be in a position to earn supernormal profits from them.

As the distinguished economist Joseph A. Schumpeter emphasized, the process of innovation—which he characterized graphically as a "process of creative destruction"[16]—is a profoundly competitive phenomenon, which, at one and the same time, creates temporary monopolies and destroys preexisting ones. Those temporary monopolies (such as are conferred, for example, by patents) provide both the necessary incentive and reward for risk-taking

[15] See also, for example, Kahn, "Review of Regulatory Framework: Telecom Public Notice CRTC 92-78," Evidence submitted to the Canadian Radio-television and Telecommunications Commission on behalf of AGT Limited, April 13, 1993.

[16] J. Schumpeter, *Capitalism, Socialism and Democracy*, Harper Colophon Books, 3rd ed. (1975), p. 81.

innovation, the primary key to economic progress. To deny an innovator the rewards of being first would inhibit innovation; and it should not matter for these purposes whether the innovator is a telephone company or a new entrant.

To require that such services be priced at cost, therefore, is likely to be counter-competitive in the most fundamental sense.

As for the concept of an essential facility—which our own suggested rules would stipulate they be mandatorily available to competitors, there is some implication in the Notice that the Commission would define a facility as essential on the basis of whether access to it promotes competitive entry.[17] We believe this definition is potentially mischievous. It is also not in accordance with general usage under the antitrust laws. According to that usage, a service or function provided by a LEC would be an essential facility only when (1) it is required by the LEC's competitors in order to offer its retail service, (2) it is available only from the LEC and (3) it is not possible technically or economically to duplicate it.[18]

This definition and prescription accords with the authoritative legal "essential facilities doctrine," which Professor Philip Areeda has characterized authoritatively in the following terms:

> There is no general duty to share. Compulsory access, if it exists at all, is and should be very exceptional. ... No one should be forced to deal unless doing so is likely substantially to improve competition in the marketplace by reducing price or by increasing output or innovation. Such an improvement is unlikely ... [when] the plaintiff is not an actual or potential competitor. ... Even when all these conditions are satisfied, denial of access is never per se unlawful; legitimate business purpose always saves the defendant....[19]

The reason we regard as potentially mischievous a definition of an essential facility any service the offer of mandatory offering of which by the LEC to potential rivals would promote competitive entry is that it would require incumbent LECs to share with their rivals any competitive advantage they might have stemming from economies of scope inherent in their

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[17] Notice, p. 24.

[18] See, for example, Baumol and Sidak, *op. cit.*, p. 93.

[19] Phillip Areeda, "Essential Facilities: An Epithet in Need of Limiting Principles," *Antitrust Law Journal*, 1990, Vol. 58, pp. 841-853.

own particular pattern of operations while imposing no such reciprocal obligation on would-be entrants—long-distance carriers, cellular operators, cable companies—which might well enjoy distinct comparable economies of their own; and so, in the name of equalizing competitive opportunities, actually discourage competition on the basis of the relative efficiencies of the several rivals and potential rivals.

The incumbent telephone companies undoubtedly enjoy or would enjoy some advantages in their offering of competitive services jointly with monopoly services: indeed these are, precisely, the economies of scope that strongly recommend permitting—indeed encouraging—them to expand their operations into the competitive sectors. The other side of that coin is that competitors will argue that those advantages should be shared—in effect, advocating a requirement of extensive unbundling of all such telephone company services, or, alternatively, depriving the telephone companies' competitive operations of those advantages as well.

Since one of us struggled with this dilemma almost ten years ago, we take the liberty of reproducing those comments:

> I have come across a recent decision of the British Office of Telecommunications Policy—OFTEL, they call it—that epitomizes the dilemma of making sensible public policy in a still highly monopolistic industry.
>
> The case involved a complaint by some small radiopaging companies that the recently privatized British Telecom, by sending its radiopaging customers a single bill covering all their telephone services and charging them only its negligible incremental billing costs—for simply adding another line to the bill—was competing unfairly, since the complaining competitors had to recover in their charges their much higher costs of billing for the radiopaging services alone. OFTEL responded by requiring British Telecom to incorporate a portion of the common billing costs in its charges for radiopaging service.
>
> The costs in question are unlikely to be decisive; but the general issue is big and crucial: should established telephone companies be permitted to charge only the incremental cost of competitive services, and if so, how can competitors dependent entirely on revenues from those services survive?
>
> Decisions like OFTEL's in this case could result in a real sacrifice of efficiency: it would tend to transfer some radiopaging business to firms with costs higher than British Telecom's, because they do not enjoy the economy of billing for several services jointly.
>
> OFTEL felt—perhaps correctly—that the longer-term benefits of competition outweighed such short-term efficiency losses. But attempting to preserve competition by handicapping competitors in this way is very dangerous. Typically, new entrants into deregulated industries enjoy advantages of their own sufficient to outweigh the possible advantages of incumbent firms—lower wages or overheads,

> greater agility or innovativeness—the very advantages that competition is supposed to bring to consumers.
>
> As a general rule, public policy should leave the determination of whether competitors deserve to survive to the unbiased test of the market itself; and that means letting all competitors—including the incumbent companies—reflect in their prices whatever economies are available to them.[20]

In addition, mandatory unbundling of non-essential facilities could impose costs on an LEC that a competitive provider would not incur and so distort the competition between them: this would be so in instances in which the costs of unbundling exceed the benefits because sufficient demand fails to materialize.

2. The exercise of downward pricing flexibility should not be linked to additional restrictions on upward flexibility

The Notice seeks comments on whether the exercise of downward price flexibility should be linked to restrictions on subsequent price increases for those services. In addition, we are concerned that it may limit the possibility of subsequent increases in the price ceilings for other services, as the arithmetic consequence of removing the price-reduced services from the price cap average.[21]

Both of these restrictions or possible restrictions, consequent upon a determination that major metropolitan markets such as San Francisco are competitive would be irrational.

a. The loss of upward flexibility in prices previously reduced

As we have already observed, a finding that a locality contains an abundance of competitive alternatives justifies *deregulation*—a freedom to reduce rates (subject only to restraints of the antitrust laws on possible predation) *and* to raise rates, as the market will allow. Above all, it is the latter policy—removal of all price *ceilings*—that is the first and most logical implication of a finding that competition is effective.

A policy that permits price reductions but not subsequent increases seems to betray the impression that in competitive markets prices only fall, never rise. As we have already observed, that impression is erroneous.

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[20] A. Kahn, regular commentary, PBS program, *Nightly Business Report*, November, 8, 1985.

[21] See our summary of its proposals, incorporated in the Notice, par. 105, at note 4, above.

The only possible consideration in favor of such an asymmetrical restriction would be that it would tend to deter predatory pricing: a policy that permits price reductions subject to the constraint that those prices may not thereafter be increased would make predation more costly and in particular prevent hit-and-run price cuts. Since we impose no such restriction in unregulated, competitive industries generally, the only justification for imposing it in this particular situation would have to be that the particular markets in question here are *especially* susceptible to successful predation: the greater the likelihood that incumbent telephone companies could *succeed* in driving competitors out of the market, thereby putting themselves in the position to earn monopoly profits, the greater the likelihood they will make such attempts and the stronger the case, therefore, for increasing the costs correspondingly by limiting their ability to increase prices after they have succeeded.

In fact, however, the very situation that would compel deregulation of telecommunications rates in concentrated metropolitan areas would also compel the conclusion that it is extremely unlikely predation could be successful there. The facilities-based competitors already have a great deal of capacity installed: firms do not exit from markets unless the prices fall and are held below their variable costs; and the very wide gap between total costs and marginal costs of capacity already in place suggests that any attempt at predation would in any event be extremely costly; the predator would have to push prices far below its own total costs and suffer large losses before it would have any hope of driving its rivals from the market. Moreover, even if Pacific's price reductions drove out such particularly unlikely targets for successful predation as AT&T, they would not drive out *facilities* already installed: the only circumstances under which it would not be profitable for anyone to continue to use the facilities would be if either that continued use were inefficient, because the marginal cost associated with it were higher than the marginal costs incurred by the incumbent, or if the incumbent persisted in pricing its competitive services below its own marginal costs—but for what purpose? Any attempt on its part to recoup those losses by raising rates above its marginal costs would not have to be combatted by the construction of new facilities: at that point, the competing facilities being already in place, it would pay someone to resume—whether the previous rivals or some successor firm—operating them. The

Commission employs almost identical logic in defending its proposal to give LEC's increasing freedom to offer contractual rates:

> We do not believe that our contract carriage proposal will lead to predatory pricing as such contracts must be made generally available and are typically long term. Further, ... predatory pricing is likely to occur only if a carrier can eliminate competition and continue to deter potential competitors from entering the marketplace. Once competitors have invested substantial sunk costs necessary to participate in the access market, the existence of those facilities will deter the incumbent from raising rates in the future.[22]

What about non-facilities-based competitors—i.e., resellers? We understand that there has been some concern expressed that even though competitive sources of dial tone are pervasive, there might be reason to expect that the competitive access providers would choose to serve only large customers and ignore small customers in those same restricted geographic areas; and that in these circumstances a complete deregulation of the incumbent would lead it freely to reduce the rates to the former while holding up the rates to the latter. If this danger were real, it would justify a solicitude for continuing opportunities for resellers to arbitrage between the low-and high-priced customers.

In fact, it seems unlikely that facilities-based competitors would simply pass by small customers in urban areas that are thoroughly traversed by competitive fiber lines: in such geographic areas, the marginal cost of hooking up smaller subscribers would be extremely low. This would be even more irrational if the incumbent company were discriminating against them.

Moreover, against this possibility of discrimination—whose imminence we are unable to assess—there are two protections that ought to suffice:

(1) Require that the LEC's contracts be filed, although unregulated, and

(2) that the LEC be subject to the requirement that it permit unlimited resale of its interstate access services. These conditions, which we understand Pacific is willing to accept, should suffice to prevent either predatory tactics directed against resellers or discrimination against smaller customers, even without reference to whether the former is otherwise likely.

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[22] Notice, p. 68.

b. The threatened loss, by simple arithmetic, of the ability to raise rates by 5 percent per year

There would be a certain superficial, mechanical logic in withdrawing an LEC's present discretionary authority to increase rates—for example, in density Zone 3—if it successfully petitions to take some services out from under price caps entirely: since one important virtue of price caps is that they permit limited rebalancings of rates included in the same band or basket, without increasing rates on average, it would seem logical, if the services whose rates were likely to be reduced are taken out of the band or basket, that the Company would lose the ability to raise other rates in the same band or basket offsettingly. But apart from that mechanical relationship of the two, there is, we believe, no substantive logic or economic validity to the proposition for a number of reasons:

1. The overwhelmingly relevant economic fact is that rates in concentrated metropolitan areas have historically been held far above cost in order to make it possible for the LECs to recover total costs while holding rates in Zone 3 down.

2. The clearest objective evidence in support of this generalization is that it is precisely these concentrated metropolitan areas—and not for the provision of basic service in rural areas—that competition has entered.

3. The purpose of an LEC seeking to remove the metropolitan area rates from regulation—and, we presume, the reason for the Commission's raising that possibility—is to give the Company greater freedom to meet that competition—whose inherent tendency must be to undermine those inflated prices. In other words, there would be every expectation by both the LEC and the Commission, if the latter accedes to the former's request, that the same tendencies will prevail in the new regime as the Commission anticipated when the rates for metropolitan and rural areas were placed in the same basket—downward in the former case, upward in the latter.

4. These offsetting tendencies, it was clearly contemplated and as in any event will be the case, are in compliance with the Commission's forthright recognition that the entry of competition undermines inefficient rate structures and requires, as the Commission itself put it, that rates be moved or be permitted to move closer to economically efficient levels—downward in the case of the metropolitan area services and upward for the rural services—directions

implicitly recognized by the FCC's having accepted population density as a surrogate for cost differentials.

5. The substantive logic of the permissible 5 percent upward increases in some components of the basket would therefore be unaffected by the Commission's recognition that competition in Zone 1 provides consumers with the fullest possible protection and that those rates can therefore safely be removed from regulation entirely. There is, to put it another way, no logic whatever in penalizing an LEC by restricting its ability to move some rates gradually up toward more efficient levels because of a finding that consumers no longer need the benefit of regulation in Zone 1 and that competition may safely be entrusted with the responsibility for moving the rates for those historically overpriced services closer to cost. Nor is there any contradiction between the latter expectation and our previous insistence that prices in competitive markets move up as well as down: as the Commission clearly recognizes, the overwhelming probability is that rates previously held far above costs by regulation will indeed decline when competitors enter.

6. Although price-cap-regulated LECs are no longer subject to rate base/rate-of-return regulation and therefore have no formal entitlement to an opportunity to recover their total costs, the fact remains that the price cap regime, with its prescribed ceilings—including the productivity adjustment—was intended to continue to give the incumbent company such an opportunity. The 5 percent upward adjustability of the Zone 3 rates was an inherent part of that calculation. Unless, therefore, the Commission is of the opinion that the greater freedom to meet competition that Pacific is seeking is likely to preserve the contribution that the Company has heretofore obtained from the far-above-cost prices in Zone 1 *more* than the downward pricing flexibility that it now enjoys under the rate caps, there is simply no basis in logic for eliminating the cushion or offset provided by incorporation of the upward 5 percent flexibility in the present rules.

Lacking that expectation—for which we can see no reasonable basis—elimination of the discretionary 5 percent increases in Zone 3 could be interpreted only as a kind of game of tit-for-tat: "We'll give you the greater flexibility that you have persuaded us you need to meet the increasingly intensive competition in Zone 1; in exchange, we demand as a ransom your surrender of the independently justified—discretionary authority to raise other rates gradually closer to economically efficient levels." The essential characteristic and virtue of competition is that it propels prices toward such levels—both the prices that regulation had previously artificially inflated and the prices that it had artificially suppressed.

III. EVALUATION OF PACIFIC'S PROPOSAL TO MODIFY PRICE REGULATION

Pacific's comments describe its proposed changes in detail. From an economic perspective, the key elements are the following:

- Streamlined regulation (outside of price caps) for contracts in competitive geographic areas—established by the existence of competitors' access networks
- Simplified basket/band structure for services remaining under price caps
- Establishment of reasonable limitations on upward price flexibility
- Ensuring that the price cap mechanism allows average price to change in a way that preserves the opportunity to recover costs.

We evaluate this proposal in terms of its consistency with the directions outlined in the previous section—namely, that it should continue to provide regulatory protection where it continues to be necessary but confine that protection to services and markets whose customers truly need it, in a manner compatible with emerging competition in other markets and with a movement overall in the direction of timely deregulation.

A. Streamlined Regulation for Contracts and Competitive Geographic Areas

1. Contracts

In general, Pacific's proposal to offer contracts under streamlined regulation is consistent with the views stated in the Notice.[23] The necessity of giving the LECs flexibility to offer contracts is now widely recognized and widely practiced in the telecommunications industry. Coupled with the safeguard that comparable contract terms be made available to

[23] Notice, pp. 67-69.

similarly situated customers (to which Pacific agrees), giving the LECs the ability to offer contracts would promote, not hinder competition.[24] We have already cited the Commission's clear recognition that this increasing freedom extended to the LECs is highly unlikely to permit predatory pricing. The same observations apply to Pacific's proposal for streamlined regulation in competitive geographic areas.

2. Competitive geographic areas

Pacific proposes that, subsequent to a showing of sufficient competition in particular areas—e.g., in the centers of major cities such as Los Angeles, San Francisco and San Jose—all access services in those areas be eligible for contract carriage. The validity of the proposal turns on the answer to two questions: (1) whether all access services in the areas identified as competitive are in the same market (so that service-by-service streamlining is unnecessary) and (2) whether competition in those areas is indeed sufficient to prevent incumbents raising prices above competitive levels.

a. Access services are in the same product market

In the context of Pacific's request, the Commission appears to answer the first question in the affirmative (observe its reference to "the access market" in Notice, p. 68); both economic analysis and empirical evidence support that view.

That the major forms of carrier access, switched and special, are in the same market is entirely consistent with the economic reasoning behind previous Commission decisions. For example, in its recent order granting non-dominant status to AT&T, the FCC concluded that all retail interexchange services were in the same product market.[25] Because carrier access services are inputs into the provision of these services, the demand for them and the characteristics of that demand (which are the basis for accessing their substitutability) are

[24] Before passage of the Staggers and Trucking Deregulation Acts of 1980, it was widely and increasingly recognized that the inability of the carriers to enter into binding long-term contracts inhibited them in their competition with one another; and that the ability to do so conferred by those acts has been a major factor in improving their services, particularly making a very large contribution to the rapid spread of highly economical just-in-time inventory systems.

[25] Federal Communications Commission, In the Matter of Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier, October 23, 1995.